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E.O. 12958: N/A
TAGS: EINV EFIN ETRD BEXP KTDB PGOV SF
SUBJECT: SOUTH AFRICA'S CREDIT RATINGS

SUMMARY

¶1. (U) From the end of June through mid-July 2004, several research and credit agencies (Fitch, Moody's Ratings, Standard & Poor's, and the Economist Intelligence Unit) presented to Johannesburg audiences their outlook and ratings for Sub-Saharan Africa and South Africa in particular. The conclusions of all four agencies were similar. All agreed that prudent fiscal and monetary policies fueled expectations of higher economic growth in 2004 and 2005; however, medium term challenges serve as constraints to long-term growth. If this growth materializes and the rand stays strong, South Africa's credit rating may improve. In addition, the November 2004 revision of gross domestic product may show actual growth to be substantially higher than previously thought as a result of improved manufacturing and services data being incorporated into GDP. All agencies noted longer-term structural problems that might inhibit improved credit ratings. Currently South Africa is rated on a par with other middle income countries but their peers do not face the same unemployment, income inequality, poverty and health problems that South Africa does. End Summary.

Similar Views on South African Perspectives

¶2. (U) Ratings agencies and research firms rate South African strengths and weaknesses similarly. Fiscal and monetary policies are deemed prudent as the budget deficit is low, foreign debt is low, inflation is under control, and the current account balance is affordable. All agencies commend the higher economic growth, with GDP growing 2.8 percent between 1994 and 2003 compared to 1.5 percent growth in the 1980s. All cite the same constraints facing South Africa in the medium term, mainly structural economic weakness against a background of inequality. These include the economic impact of HIV/AIDS, low levels of savings and investment, rigidities in the labor market. Ratings agencies cite the low levels of reserves as an impediment to an upgrade in credit ratings. However, Moody's Credit Ratings Officer thought that a ratings review of South Africa might be in order if revised GDP growth turns out to be significantly higher when the November 2004 GDP revision is due.

Fitch Ratings

¶3. (U) Fitch Ratings emphasized improved growth prospects in Sub-Saharan Africa, for 2004 and 2005, 4.5 percent and 4.7 percent, respectively, compared to 2.7 percent in 2003. In March 2004, Fitch again rated South Africa's long-term foreign currency "BBB", and its long-term local currency at "A minus" with a stable outlook, unchanged from its May 2003 ratings. Other peer countries in this category include Thailand and Tunisia. Countries rated one-notch above at BBB plus include Latvia, Lithuania, Malaysia, Poland and Slovakia. Countries one notch below include Croatia and Mexico.

¶4. (U) Fitch cited improvement in the public and external debt ratios, falling inflation, and the elimination of the net open foreign position leading to an improvement in South Africa's liquidity indicators as positive developments. Low investment, social and economic inequities, and lower growth than peer countries were factors on the negative side. Fitch analysts noted that South Africa and Nigeria were the engines for growth in Sub-Saharan Africa and that South African firms had been rapidly increasing their investment in the rest of Africa. One issue raised is whether the rapid

increase of South African investment in 2003 is sustainable, given the relatively small domestic markets in other African countries.

Moody's Ratings

¶5. (U) Moody's feels that its optimistic perspective in 1994 was vindicated. Since 1994, Moody's has raised its "Baa3" country rating to Baa2 in 2001, and in February 2003 assigned a positive outlook to its Baa2 long-term foreign currency ratings. Credit Ratings Officer Kristin Lindow suggested that South Africa might warrant another review if it turns out that past growth was seriously underestimated because incomplete coverage of both the manufacturing and service sectors in the national income accounts. Faster actualized growth may improve investor perceptions towards viewing South Africa as a fast growing market with high investment potential.

¶6. (U) The reasons for the most recent credit outlook upgrade to positive are the similar for Moody's as other ratings agencies. Falling inflation, low domestic and foreign debt, lower interest rates, and improving external liquidity made South Africa a better credit risk. On the negative side, Moody's May 2004 Analysis also lists the serious economic and social challenges ahead, namely managing HIV/AIDS pandemic, reducing income disparities, making inroads on unacceptably high levels of unemployment, and increasing investment in a climate compounded by low domestic savings and low foreign direct investment, and exchange rate volatility. One distinguishing characteristic of Moody's analysis is the emphasis it placed on political developments, including mentioning the uncertainty clouding the next five years over the succession question in the African National Congress. Since foreign direct investment is low, Kristin Lindow's views are that the source of higher South African growth has to be domestic investment. Because foreign portfolio investment far exceeds foreign direct investment, its capital flows are more volatile and short-term oriented. Moody's does not foresee a change in the distribution of South African foreign investment.

¶7. (U) Lindow also believes that the South African Reserve Bank should increase its foreign reserves. She points out that South Africa's $10 billion in reserves is well behind the $20 billion in reserves in its peer group. On the bright side, commercial bank foreign assets have grown from $7.7 billion at the end of 2002 to $16.3 billion by the end of April. Moody's counts Malaysia, Saudi Arabia, Bahrain, Mexico and India as peer countries.

Standard & Poor's Ratings

¶8. (U) In June 2004, Standard and Poor's rated 11 African countries at the request of United Nations Development Program, including South Africa. Of the 11 countries, Tunisia and South Africa received the highest long-term foreign currency rating at "BBB". South Africa received the most improved rating since its initial 1994 rating of "BB", reflecting progress in fiscal and monetary reforms. Standard & Poor's includes Mexico, Tunisia, Thailand, Oman, China and the Slovak Republic as South Africa's country peers. South Africa's socioeconomic problems of high unemployment, income and land distribution inequalities, skills shortage, high crime rates, HIV/AIDS pandemic, and low economic growth are more severe than those faced by its peers. These challenges are counterbalanced by better fiscal and monetary policies and transparency in budgeting and planning compared to peer practices.

Economist Intelligence Unit's Analysis

¶9. (U) The Economist Intelligence Unit (EIU) produced a South African country report in June 2004 primarily expecting an increase in growth over the next two years compared to 2003's 1.9 percent due to robust foreign growth, further strength in domestic demand and growth in tourism. Increasing foreign demand will help boost exports, but rising imports will lead to a gradual reduction of the trade surplus and a modest deterioration of the current account deficit to 1.7 percent of GDP in 2004 and 2 percent in 2005. EIU's forecast is for a weaker rand in 2005 as interest rate differentials begin to

subside with the global trend towards higher interest rates. The EIU offers economic analysis but does not rate countries.

¶10. (U) The EIU's country report provides more detailed coverage of both the political, industrial and financial sectors than the ratings agencies; however, the focus is short-term, with 2005 as the latest forecast year. EIU considers rigid labor legislation and regulations concerning employment as a major obstacle to more rapid job creation in the private sector and doubts that GDP growth rates will reach 5 to 6 percent. It cites a recent study by a research group chaired by Roger Baxter of the Chamber of Mines concluding that the low level of domestic investment is the major reason for lackluster growth rates. The study argues that local business fails to invest because the cost of capital is 8.5 percent when the average real rate of return from listed companies is 8.6 percent. The high cost of capital was the result of high real interest rates, volatile inflation and exchange rates, high corporate tax rates, and the perceived risk of doing business in Africa.

Comment

¶11. (U) All analyses point to the same past fiscal and monetary successes combined with serious mid to long-term challenges that South Africa must overcome before it qualifies for higher ratings. The private sector will be the source of new jobs; however, skills, labor flexibility, and investment would have to be seriously improved before South Africa experiences high enough growth to reduce poverty and unemployment. Nevertheless, South Africa remains the engine for Africa's growth; the IMF estimates that every 1 percent increase in South Africa's growth, sustained over five years, will add between 0.4 and 0.7 percent to African growth. South Africa will have to increase domestic investment, upgrade skills, attract more foreign investment, and provide a more flexible labor environment to change the views of these ratings agencies in a favorable way.
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